

Internal Revenue Service

memorandum

CC:TL-N-6206-88

Brl:LJFernandez

date: JUL 22 1988

to: District Counsel, Los Angeles
Attn: Charles O. Cobb
Aerospace Industry Counsel

CC:LA

from: Director, Tax Litigation Division

CC:TL

subject:

Designation as Litigation Vehicle

This is in response to your request that the above-captioned case be designated for litigation in the Aerospace Industry Specialization Program pursuant to CCDM (35)(3)(14)4(5). Your request to have this case designated has been coordinated with and is concurred in by both the Aerospace Industry Specialist and the Appeals Aerospace Industry Coordinator.

ISSUE

Whether income and expenses attributable to service oriented activities such as engineering, design and equipment maintenance that would not qualify for the long-term methods of accounting if contracted for separately may be "carved out" of an otherwise qualifying manufacturing contract.

CONCLUSION

The facts developed in [REDACTED] demonstrate that it is an appropriate vehicle to litigate the position that service oriented activities should be "carved out" of a contract that otherwise qualifies for the long-term methods.

FACTS

[REDACTED] ([REDACTED]) engages in the application of scientific expertise and computer and systems technology to solve complex technical problems primarily in three fields: (1) [REDACTED], which includes [REDACTED], [REDACTED], and [REDACTED] analysis, (2) [REDACTED], which includes [REDACTED] research, [REDACTED] projects and [REDACTED] studies and (3) [REDACTED] and

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[REDACTED], which includes [REDACTED] development and [REDACTED] analysis.^{1/} This request for designation concerns [REDACTED]'s activities described in (1) above for its fiscal years ended [REDACTED], [REDACTED] and [REDACTED].

With regard to the "carve out" issue, the examining revenue agent has proposed adjustments concerning [REDACTED] contracts for which [REDACTED] utilizes the completed contract method of accounting. See Revenue Agent's Report (RAR) Issues 44-72. The first [REDACTED] contracts (RAR Issues 44-71) require [REDACTED] or one of its subsidiaries to manufacture deliver and, in some cases, install hardware for a customer. As of [REDACTED]'s fiscal year ended [REDACTED], the hardware required by these contracts had not been accepted by the customers.

The contracts also require performance of activities other than the manufacture or installation of hardware. Each of these contracts contain the following items: (1) Program management, (2) engineering and design, (3) software development, (4) equipment maintenance, (5) training and preparation of manuals, (6) data and document control, (7) field support, (8) hardware acquisition support, (9) other nonmanufacturing or noninstallation support, (10) other nonmanufacturing or noninstallation activities. The revenue agent proposes that these items be "carved out" of the otherwise qualifying long-term contracts and that the income and expense from such items be reported under [REDACTED]'s right-to-bill accrual method. The proposed adjustments for these [REDACTED] contracts over the three years involved total approximately \$ [REDACTED].

The [REDACTED]th contract (RAR Issue 72) is entitled the [REDACTED]. On [REDACTED], [REDACTED] entered into a contract with the [REDACTED] for the implementation of a command, control and communications system in [REDACTED] for the [REDACTED]. This contract called for the construction of three systems: a manual system, an automated information handling system and a fully automated system.

During the prior audit cycle the manual system was completed and removed from the remainder of the contract. The activities performed by [REDACTED] for years covered by the subject audit on the automated information handling system and the fully automated system may be divided into the following categories: (1) program

^{1/} [REDACTED]
[REDACTED].

management, (2) engineering and design, (3) software development, (4) equipment maintenance, (5) training and manuals, (6) data and document control, (7) field support, (8) hardware acquisition support, (9) other support (10) other nonmanufacturing or noninstallation activities and (11) system manufacturing and installation. A detailed description of these activities may be found at pp. 149-157 of the RAR. The revenue agent also proposes that these items be "carved out" of the contract with the exception of actual manufacturing and installation. The proposed adjustment for this contract alone totals over \$ [REDACTED].

The "carve out" issue also arises as an alternative argument with regard to proposed adjustments in several other contracts. Although this designation request concerns the "carve out" issue, several other issues are present in this case. The other issues are "contract closure", "contract severing" as well as the "unique items" issue. All of these secondary issues are of great importance to the Aerospace Industry Specialization Program.

DISCUSSION

I.R.C. § 451 provides that any item of gross income shall be included in the gross income of a taxpayer for the tax year in which the item is received by such taxpayer, unless, under the accounting method used by the taxpayer in computing taxable income the item is properly accounted for as of a different period.

Treas. Reg. § 1.451-3(a)(1) allows income from a long-term contract, as defined in Treas. Reg. § 1.451-3(b)(1), to be included in gross income in accordance with one of two long-term contract methods or any other method that clearly reflects income. These prescribed long-term methods are: (1) the percentage of completion method as described in Treas. Reg. § 1.451-3(c), and (2) the completed contract method as described in Treas. Reg. § 1.451-3(d).

The percentage of completion method and the completed contract method apply only to the accounting for income and expenses attributable to long-term contracts. Other income and expense items such as investment income, expenses not attributable to such contract, and costs incurred with respect to any guarantee, warranty, maintenance or other service agreement relating to the subject matter of such contracts shall be accounted for under a proper method of accounting. Treas. Reg. § 1.451-3(a)(3).

Treas. Reg. § 1.451-3(b)(1)(i) states that, except as provided in subdivision (ii), the term "long-term contract" means a building, installation, construction or manufacturing contract that is not completed within the tax year in which it is entered.

The Service has traditionally viewed certain service oriented activities as ineligible for the long-term methods if such contracts were contracted for separately. As early as 1930 the Service took the position that a contract for an architect's services that called for building plan drawings and supervision of construction did not qualify for reporting under the long term methods. [REDACTED] G.C.M. 7998, A-239197 (1930), superseded by, Rev. Rul. 70-67, 1970-1 C.B. 117. Later revenue rulings conclude that contracts for design, engineering and construction management services do not qualify for the long-term methods because the work performed by the contractor under such contracts is not building, construction or manufacturing but, rather, is in the nature of personal services. See Rev. Rul. 70-67; Rev. Rul. 80-81, 1980-1 C.B. 103; Rev. Rul. 82-134, 1982-2 C.B. 88; Rev. Rul. 84-32, 1984-1 C.B. 129.

When service oriented activities are included in a contract that also provides for manufacturing or construction, Counsel's position is that under certain circumstances the service oriented activities must be "carved out" of the otherwise qualifying contract and reported under an appropriate method. [REDACTED] v. Commissioner, O.M. 19961, I-194-84 (November 6, 1984). See also PLR 8249007; PLR 8308005; PLR 8623001. This position has not yet been tested in the courts.

O.M. 19961 considers a taxpayer engaged in providing engineering services to, as well as constructing and installing offshore oil drilling platforms for, companies in the marine construction industry. Taxpayer entered into a single contract with a customer to provide engineering, design, fabrication and installation of an oil drilling platform. Taxpayer's various divisions would perform the different functions. The engineering and design work would be done by taxpayer's engineering division at a centrally located office. Such work includes the basic structural design, a model study, detailed design of electrical systems and wiring systems, and detailed engineering of the load out, transportation, launch, upend, installation and grouting of the platform.

The O.M. concludes that when engineering, design or supervision is called for by a contract for the building, installation, construction or manufacture of an item, the engineering, design and supervision services are not qualified for the long-term methods except to the extent such services are to be performed during and are incidental to the building, installation construction or manufacture of the item.

The instant case provides an excellent vehicle for litigation. The issue is set forth in contracts involving a variety of factual scenarios that allow the Service a great deal of flexibility in presenting the issue in a light most favorable

to the government. The case contains contracts that require the performance of activities that are specifically proscribed from being reported under the long-term methods by Treas. Reg. § 1.451-3(a)(3). The income and expenses attributable to such activities may be "carved out" based upon the authority of the regulations. The instant case also contains contracts requiring the performance of service oriented activities that are performed prior to, or are otherwise separate from, the manufacturing effort. Thus, a basis for litigating the position set forth in O.M. 19961 is presented.

We also believe the case presents an excellent opportunity to explore whether service oriented activities that are performed during and are incidental to the manufacturing effort may be "carved out". Although O.M. 19961 appears to allow such activities to be reported under the long-term methods, the issue is being revisited. See Aerospace ISP Litigation Position Paper Re: Carve Out. In fact, a policy paper prepared by the Corporation Tax Division for review at the Associate Chief Counsel (Technical and International) level recommends that service oriented activities such as design, engineering and construction management that are performed during and are incidental to manufacturing or construction not be permitted to be reported under the long-term methods.

DESIGNATION

For reasons stated above, the "carve out" issue for the tax years [REDACTED], [REDACTED] and [REDACTED] is designated for litigation pursuant to the provisions CCDM (35)3(14)4(5).


MARLENE GROSS

cc: Director, Appeals Division
ISP Manager
Aerospace Industry Team